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It’s No Fable: ESOPs Can Protect Indiana Jobs

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State Treasurer Richard Mourdock recently introduced a bold initiative that will keep participating Hoosier companies in-state while increasing worker productivity, a welcome move for Indiana companies, their owners and employees.

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The Indiana Employee Stock Ownership Program (ESOP) Initiative, or IEI, encourages Indiana business owners to sell their companies to a retirement plan established for their employees called an ESOP, which helps employees save for retirement while giving them a tangible, financial incentive to help the company succeed.

Treasurer Mourdock’s office has pledged to fund the $500,000-per-year program and subsidize up to $5 million per ESOP transaction — without creating additional burdens for Indiana taxpayers. The money will come from the estimated $400 million to $700 million the state already invests in Indiana financial institutions.

As further explained on Treasurer Murdock’s Web site, a basic transaction involves a lender loaning money to the ESOP, which then uses the borrowed money to buy stock from the company or its shareholders. Simultaneously, the ESOP signs a note with the lender and pledges the stock as collateral, with the acquired company then likely guaranteeing the repayment of the loan. In general, the transaction looks similar to other business transactions; however, by participating in the new IEI program, the borrowing costs, including the interest rate, can be significantly reduced.

Over time, usually 10 years or less, stock held in the ESOP is allocated to each participating employee as the business makes contributions to the ESOP, which in turn uses the company’s contributions to repay the loan and interest. Whereas, repayments of loan principal would normally not be deductible, the entire amount of the company’s contributions paid to the ESOP should be fully deductible, which is equivalent to the company taking a tax deduction for payment of both the loan principal and interest. Furthermore, the contributions made to the ESOP are not taxable to the participating employees until they subsequently receive their distributions from the ESOP following retirement.

In addition to the new cost-saving benefits offered by IEI, ESOPs offer other material benefits for the company, employees and shareholders. For example, Subchapter S corporations that create ESOPs can eliminate all income tax liability on their business operations. An S corporation is generally not subject to income tax, but its shareholders remain taxable upon their share of the S corporation’s earnings. However, since an ESOP is a tax-exempt trust, S corporation earnings allocated to the ESOP are not taxable, and if the ESOP owns 100 percent of the corporation’s shares, for the benefit of participating employees, there is no income tax payable on the business operations.

The potential 35 percent or more in income tax savings can then be reinvested in the company, thereby increasing the value of the shares held in the ESOP, the value of which is ultimately realized by the employees participating in the ESOP.

An ESOP is also an ideal way to buy out shareholders. For example, assume a private company’s founders want to retire, but their children have no interest in running or owning the business. The founders wish to preserve the business for their long-term and key employees, but none of these individuals have the financial ability to make the purchase. In this situation, the founders may believe that their only option is to sell the business to an outside group that may decide to move the business out-of-state, thereby placing the current employees at risk of losing their jobs.

3y establishing an ESOP, a new buyer is created that will still pay the founders fair market value for the company, but this ESOP ɔuyer will represent the interests of the company’s current employees, making it very unlikely that the company will move from its ɔurrent Indiana location.

Even if the founders do not sell 100 percent of the business to the ESOP, the founders can utilize the ESOP to help diversify their ɔersonal assets in a tax-deferred manner. In many private companies, the majority shareholder’s single largest asset is his or her nterest in the company. To spread investment risk, the shareholder could sell part of his or her stock to an ESOP, pay the capital gains tax on the net gain and then reinvest the after-tax proceeds.

However, if the ESOP holds at least 30 percent of the company’s total outstanding shares after its purchase, the selling stockholder may be able to defer the payment of income tax on this sale by promptly reinvesting the total sale proceeds in a broad range of replacement investments. Only when these replacement assets are subsequently sold will the deferred gain be taxed and in the meantime, the selling shareholder is able to realize additional earnings on the deferred tax amount.

Even with all of the benefits offered by ESOPs, including the new benefits the state’s new IEI program offers, companies and shareholders need to understand that ESOPs are subject to various tax rules and regulations. Furthermore, if the value of the company should decrease, the employees share in this loss in value because they own part of the company through their ESOP. Nevertheless, the potential return that can be realized from an ESOP’s investment in a company is real and can be very significant, and few other investments allow employees to realize a return from their day-to-day working efforts.

The combination of the new financial benefits of the state’s IEI program, together with the other ESOP incentives and benefits offered to companies, shareholders and employees, cause ESOPs to be a financial tool that many successful Indiana companies can and will establish.

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